

OPENING STATEMENT OF  
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“THE ROLE OF THE SEC IN PROMOTING  
CAPITAL FORMATION: HELP OR HINDRANCE”  
JUNE 26, 2001

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Good morning Chairwoman Kelly and thank you for holding this hearing. I would like to welcome all of the panelists who have come here today to share their views on the important issue of capital formation. I am pleased to be here today.

The mission of the U.S. Securities and Exchange Commission is to protect investors and promote efficient capital formation. The challenges facing the Commission in accomplishing its mission are no different today than the challenges that existed in 1933, when the U.S. federal government first began regulating issuance of securities. The premise of the ‘33 Act is that full and fair disclosure will most effectively promote efficient and fair functioning of the process of capital formation.

We are here today to study and discuss possible changes to the existing regulatory structure to facilitate capital formation for small businesses and all market participants.

Small businesses are an important source of economic growth and job creation. They account for 50 percent of the gross domestic product and the majority of new jobs created. In terms of innovation, it is estimated that small firms produce twice as many product innovations per employee as large firms, creating new products, services, lines of business and industries.

Access to capital is a critical issue for small businesses. Without sufficient capital, small firms are unable to develop new products and services or grow to meet demand. Insufficient liquidity is a frequently cited cause of small business failure. Small firms are heavily dependent on bank loans, trade credit and informal sources of financing such as personal savings, credit cards, home equity loans and loans from family and friends.

Steps have been taken by both federal securities regulators and state governments in an attempt to reduce some of the regulatory burden and costs for small

businesses seeking equity capital financing in the regulated securities market. One of the steps taken by federal securities regulators has been simplifying federal registration of securities offerings and exempting certain small business securities offerings from several requirements (Regulation D) in an attempt to reduce the regulatory burden and costs for small businesses in equity capital formation.

One of these exemptions, Rule 504 under Regulation D, is intended to allow companies to raise “seed capital.” A company may privately sell up to \$1 million of securities in a 12-month to any investor without registration as long as there is no public solicitation or advertising and resale of the shares is restricted. A company may sell the same amount of securities using public solicitations if it has registered the securities in a state that requires (1) public filing of a registration statements with the state and (2) delivery of disclosure documents to investors.

From 1992 to 1999, the SEC dropped the state registration requirement from Rule 504. They then experienced a substantial increase in the number of complaints they received from investors who had been defrauded by operations selling shares under Rule 504. The SEC found that fraudulent operations had developed that would go to states that had no substantive registration requirements and sell securities to residents of those states. This resulted in substantial incidents of fraudulent sales to the general public of securities for which no information was publicly available.

Another step taken by the SEC to minimize the regulatory costs of raising equity capital, has been permitting small business issuers to use simplified small business forms (the so-called SB-1 and SB-2) in filing registration statements. Small business issuers are those with less than \$25 million in revenues in the last fiscal year and outstanding stock of \$25 million or less.

Even though these forms save an issuer up to approximately \$125,000 for an average offering, small business issues are viewed unfavorably by many investment bankers because they are too small in size to be profitable. Also, small offerings are commonly distributed by smaller investment banks that lack market recognition, which can be an impediment to attracting investors.

These problems show that even though many positive steps have been taken to help small businesses gaining access to equity capital, more needs to be done.

By passing “the Capital promotion tools in the National Securities Markets Improvement Act” in 1996, we sought to enhance the Commission’s role in

promoting capital formation and efficiency with the appropriate investor protections. It is crucial then that the SEC balance the burden placed in small businesses against the purposes of investor protections under the securities laws.

I look forward to hearing all of the testimonies.

Thank you Madame Chairwoman.